CMA US Notes: Leases, Common Stock, and Business Combinations

Leases

Definition

A **lease** is a contractual agreement between a **lessor** (the asset owner) and a **lessee** (the entity using the asset), granting the lessee the right to control the use of a specific asset for a defined period in exchange for periodic payments.

Types of Leases for Lessees

Finance Lease

A lease is classified as a **finance lease** if it meets **one or more** of the following criteria under US GAAP:

1. **Ownership transfer**: The lease transfers ownership of the asset to the lessee by the end of the lease term.
2. **Purchase option**: The lessee has an option to purchase the asset and is reasonably certain to exercise it.
3. **Lease term**: The lease term covers the major part of the asset's economic life (typically ≥75%).
4. **Present value**: The present value of lease payments equals or exceeds substantially all of the asset's fair value (typically ≥90%).
5. **Specialized asset**: The asset is highly specialized and has no alternative use to the lessor at the end of the lease term.

Accounting:

- Recognize a **right-of-use (ROU) asset** and a **lease liability** at the lease commencement on the lessee's balance sheet.
- Amortize the ROU asset over the lease term.
- Interest expense on the lease liability is recognized separately from amortization.

Operating Lease

If **none** of the finance lease criteria are met, the lease is classified as an **operating lease**.

Accounting:

- Recognize a **right-of-use (ROU) asset** and a **lease liability** at lease commencement.
- Record a single **lease expense** on a straight-line basis, combining interest and amortization in the income statement.
- No separate interest or amortization expense is reported.

Short-Term Leases

- Leases with a term of **12 months or less** (including any reasonably certain renewal options) qualify as short-term leases.
- Lessees may elect not to recognize an ROU asset or lease liability, treating payments as **lease expense** on a straight-line basis.
- **Example**: A 12-month lease with a renewal option the lessee is likely to exercise does **not** qualify as a short-term lease and requires ROU asset and liability recognition.

Leases on the Statement of Cash Flows

- **Finance Leases**:
  - Principal repayments of the lease liability are classified as **financing activities**.
  - Interest payments are classified as **operating activities**.
- **Operating Leases**:
  - Lease payments are classified as **operating activities**.

IFRS Lease Notes

- Under **IFRS**, there is **no distinction** between finance and operating leases for lessees.
- All leases (except short-term and low-value leases) are accounted for similarly to US GAAP finance leases, with an ROU asset and lease liability recognized.

Common Stock

Definition

Common stock represents the most common form of equity ownership in a corporation, granting shareholders voting rights and a share of profits through dividends or capital appreciation.

Key Concepts

Par Value of Common Stock

- **Par value** is the nominal or stated value printed on the stock certificate.
- Represents the minimum legal capital that cannot be distributed as dividends.

No-Par Value Common Stock

- For **no-par stock**, the **legal capital** is the total amount received upon issuance.
- No arbitrary par value is assigned.

Legal Capital

- The portion of contributed capital required by law to be retained in the business.
- Cannot be distributed as dividends to protect creditors.

Issuing Common Stock for Cash

Journal Entry:

Dr Cash	[Amount received]

Cr Common Stock [Par value × Shares issued]

Cr Additional Paid-In Capital (APIC) - Common Stock [Excess over par]

Share Issuance Costs

- Costs (e.g., legal or underwriting fees) reduce the cash received and are deducted from **APIC**.

Issuing Common Stock for Non-Cash Assets

- Record at the **fair market value** of the asset received or the stock issued, whichever is more reliably determinable.
- **Example**: Issuing 1,000 shares for equipment with a fair value of $50,000:

Dr Equipment 50,000

Cr Common Stock [Par value × 1,000]

Cr APIC - Common Stock [50,000 - Par value]

Common Stock Dividends

Types of Dividends

1. **Cash Dividends**: Cash payments to shareholders.
2. **Liquidating Dividends**: Paid when no retained earnings exist, reducing legal capital.
3. **Property Dividends**: Distribution of non-cash assets (e.g., inventory or equipment).
4. **Stock Dividends**: Additional shares issued to shareholders.

Cash Dividends

Three Steps:

1. **Declaration**: Board declares the dividend, creating a liability.

Dr Retained Earnings [Dividend amount]

Cr Dividends Payable [Dividend amount]

2. **Record Date**: No journal entry; determines eligible shareholders.
3. **Payment Date**: Cash is paid to shareholders.

Dr Dividends Payable [Dividend amount]

Cr Cash [Dividend amount]

Liquidating Dividends

- Paid when retained earnings are insufficient, reducing contributed capital.

Dr Contributed Capital [Dividend amount]

Cr Cash [Dividend amount]

Property Dividends

- **Accounting**:
  - Debit **Retained Earnings** for the **fair value** of the asset distributed.
  - Write off the asset at its **book value**.
  - Recognize any difference as a **gain or loss** in continuing operations.
- **Journal Entry**:

Dr Retained Earnings [Fair value of asset]

Dr Loss on Disposal [If book value > fair value]

Dr Accumulated Depreciation [Historical cost]

Cr Asset [Historical cost]

Cr Gain on Disposal [If fair value > book value]

Stock Dividends

- **Small Stock Dividends** (<20-25% of outstanding shares):
  - Valued at **fair market value** on the declaration date.
  - **Journal Entry**:
- Dr Retained Earnings [FMV × Shares issued]
- Cr Common Stock [Par value × Shares issued]
- Cr APIC - Common Stock [FMV - Par value]
- **Large Stock Dividends** (>20-25% of outstanding shares):
  - Valued at **par value**.
  - **Journal Entry**:
- Dr Retained Earnings [Par value × Shares issued]
- Cr Common Stock [Par value × Shares issued]

Stock Splits

- Increase the number of shares outstanding and reduce the par value proportionally.
- **No journal entry** is required.
- Affects **outstanding shares** but not **authorized shares**.

Preferred Stock

Definition

Preferred stock is a class of equity that typically offers fixed dividends and priority over common stock in asset distribution but does **not** grant voting rights.

Advantages of Preferred Stock

1. **Preference in claims**: Preferred shareholders have priority over common shareholders in asset distribution during liquidation.
2. **Fixed dividends**: Provide predictable income.

Preferred Stock vs. Bonds

- Failure to pay preferred dividends does **not** constitute a default, unlike bond interest.
- Preferred dividends are **not tax-deductible**, unlike bond interest.

Types of Preferred Stock

1. **Redeemable**: Can be repurchased by the company at a specified price.
2. **Convertible**: Can be exchanged for common stock at the shareholder's option.
    - No gain or loss is recorded; the common stock replaces preferred stock at book value.
3. **Callable**: Can be retired at the company's option.

Preferred Dividends

- **Calculation**: Expressed as a percentage of par value (e.g., 5% of $100 par = $5 per share).
- **Types**:
    1. **Noncumulative**: Missed dividends are not owed in the future.
    2. **Cumulative**: Missed dividends (dividends in arrears) must be paid before common dividends.
        - **Disclosure**: Dividends in arrears are **not** a liability but must be disclosed in financial statement notes.

Participating Preferred Dividends

- Preferred shareholders may receive additional dividends alongside common shareholders if specified in the share agreement.

Classification of Shares

Key Terms

1. **Authorized Shares**: The maximum number of shares a company can issue, as per its charter.
2. **Issued Shares**: Shares sold to investors at any point.
3. **Outstanding Shares**: Shares currently held by investors (issued minus treasury stock).

Impact of Transactions

Transaction	Affects Authorized	Affects Issued	Affects Outstanding
Stock Split	No	Yes	Yes
Stock Dividend	No	Yes	Yes
Treasury Stock	No	No	Yes

Treasury Stock

Definition

Treasury stock consists of shares repurchased by the company after being issued to the public.

Reasons for Purchasing Treasury Stock

1. Provide a market for the company's shares.
2. Reconsolidate ownership.
3. Investment if shares are undervalued.
4. Use in stock dividends or employee compensation plans.

Characteristics

- Treasury stock does **not** receive dividends.
- Has **no voting rights**.
- Is **not** classified as outstanding.

Accounting

- **Purchase**:

Dr Treasury Stock [Cost of shares]

Cr Cash [Cost of shares]

- **Sale** (if sold above cost):

Dr Cash [Proceeds]

Cr Treasury Stock [Cost]

Cr APIC - Treasury Stock [Excess]

Business Combinations and Consolidations

Definition

A **business combination** occurs when one entity acquires control over another business. **Consolidation** is the process of combining the financial statements of a parent company and its subsidiaries into a single set of financial statements.

Key Concepts

1. **Acquisition Method**:
    - The acquirer recognizes the **fair value** of identifiable assets acquired, liabilities assumed, and any noncontrolling interest.
    - **Goodwill** is recorded if the purchase price exceeds the fair value of net assets.
    - **Journal Entry** (simplified):
2. Dr Assets (at fair value) [Fair value]
3. Dr Goodwill [Excess purchase price]
4. Cr Liabilities [Fair value]
5. Cr Cash/Stock [Purchase price]
6. Cr Noncontrolling Interest [If applicable]
7. **Consolidation**:
    - Combine 100% of the subsidiary's assets, liabilities, revenues, and expenses with the parent's financials.
    - Eliminate intercompany transactions (e.g., sales, loans).
    - Adjust for **noncontrolling interest** if the parent owns less than 100%.

Example Problem: Business Combination

Scenario: Parent Co. acquires 80% of Sub Co. for $800,000 cash on January 1, 2025. Sub Co.'s net assets have a book value of $700,000 and a fair value of $900,000. Calculate goodwill and prepare the consolidation entry.

Solution:

1. **Goodwill Calculation**:
    - Purchase price: $800,000
    - Fair value of net assets acquired (80%): $900,000 × 80% = $720,000
    - Goodwill = Purchase price - Fair value of net assets = $800,000 - $720,000 = **$80,000**
    - Noncontrolling interest (20%): $900,000 × 20% = **$180,000**
2. **Consolidation Journal Entry**:

Dr Assets (Sub Co.) 900,000

Dr Goodwill 80,000

Cr Cash 800,000

Cr Noncontrolling Interest 180,000

3. **Consolidation Notes**:
    - Eliminate Sub Co.'s equity accounts (e.g., common stock, retained earnings).
    - Adjust Sub Co.'s assets/liabilities to fair value in the consolidated financial statements.